Colonial First State

Market Watch

August 2015

Read the latest market update from the Economic and Market Research team at Colonial First State Global Asset Management.

Economics overview

Australia

- The RBA left the official cash rate on hold at 2% at its meeting on 1 September 2015 where it has remained since May this year.
- In making its decision the Board noted that "the global economy is expanding at a moderate pace, with some further softening in conditions in China and east Asia of late, but stronger US growth."
- The RBA noted that "equity markets have been considerably more volatile of late, associated with developments in China, though other financial markets have been relatively stable."
- On Australia a "moderate expansion in the economy continues" with the RBA reinforcing the disparity between the better labour market data and below trend economic growth, leading to ongoing spare capacity in the economy and contained inflation.
- As a result "monetary policy needs to be accommodative" and "further information on economic and financial conditions to be received over the period ahead will inform the Board's ongoing assessment of the outlook and hence whether the current stance of policy will most effectively foster sustainable growth and inflation consistent with the target."
- Q2 2015 GDP data was received in early September with soft growth of just 0.2% per quarter recorded. This took annual growth down to just 2%, the lowest level since Q3 2013.
- More importantly the income side of the Australian economy was weaker, with real gross domestic income at -0.4% per quarter and -0.2% per year.
- The main contributors to growth in Q2 2015 were consumer spending and government spending while negatives were dwelling investment, net exports and inventories.
- Employment figures continued to surprise on the upside with 38,500 jobs added in July. The unemployment rate did rise to 6.3% from 6.1% with an increase in the participation rate.
- Despite better labour market numbers, wages growth remains weak, at 2.3%per year, the lowest on record.
- Consumer confidence rebounded 7.8% in the month after falling 3.2% in July. Business confidence did slip, falling to 4 from 8.
- Australian house prices rose 0.3% in August, following a 2.8% rise in July. This took annual house price growth to 10.2%per year, down from, 11.1%per year in July. On a capital city basis Sydney (+1.1%) and Adelaide (+0.7%) rose while Melbourne and Brisbane were flat and Perth retreated 1.3%.

US

- There was no meeting of the US Federal Open Market Committee (FOMC) in August, with the next meeting to be held on 16-17 September 2015.
- Despite no meeting being held, there remained furious debate about the expected timing of the first rise in the Fed Funds rate.
- Debate escalated given the extreme volatility in financial markets over August, weaker commodity prices and signs of weaker growth in China.
- At this stage domestic economic activity indicators continue to point towards the need for higher interest rates in the US; Q2 2015

GDP was revised higher in the second estimate and is now at 3.7% on a seasonally-adjusted-annualised-rate, up from 2.3% in the first estimate. There were upward revisions to consumer and business spending, as well as inventories.

- On employment, there were further positive signs in the month with 215,000 jobs added in the month of July. The unemployment rate held steady at 5.3% over the month. Despite continued improvements in the labour market, average hourly earnings remain subdued, rising to 2.1% per year, from 2.0% per year.
- On inflation however the debate remains about how soon it will return to the Federal Reserve's 2% mandate. For July, Headline CPI was 0.2%per year, Core CPI was 1.8%per year and the Fed's preferred measure, Core Personal Consumption Expenditure Index fell to 1.2%per year from 1.3%per year.
- Despite below target inflation, comments from Vice Chairman Stanley Fischer at the annual Jackson Hole Symposium suggested "given the apparent stability of inflation expectations, there is good reason to believe that inflation will move higher as the forces holding down inflation dissipate further."
- He went on to note "With inflation low, we can probably remove accommodation at a gradual pace. Yet, because monetary policy influences real activity with a substantial lag, we should not wait until inflation is back to 2% to begin tightening."
- Despite these comments, and reasonable domestic economic data, there remained at the end of August only a 42% chance of a rate hike priced in for the September meeting.
- The US Dollar Spot Index fell 1.6% in August, with the USD falling against both the Japanese yen and euro in the month.

Europe

- The European Central Bank (ECB) did not meet in August. The main refinancing rate remains at 0.05% and a target of €60bn of securities are to be purchased each month.
- EU Finance Ministers agreed to a €86bn third bail-out package for Greece. This allowed Greece to receive the first tranche of funding from the European Stability Mechanism in time to repay the European Central Bank its bond maturing.
- In return Greece has agreed to target a medium-term primary government surplus of 3.5% of GDP, including a path of -0.25% in 2015, +0.5% in 2016, 1.75% in 2017 and 3.5% in 2018.
- With the agreement of the third bail-out package, Greek Prime Minister Alexis Tsipras resigned with fresh elections due 20 September. He will stand for re-election in an attempt to unite support for the agreement.
- In economic news Q2 2015 GDP data was released. On the whole, the Eurozone grew by 1.2% per year; however this hides significant divergence between countries. Spain (+3.1% per year) and Germany (+1.6% per year) were the top performers, elsewhere Portugal (+1.5% per year), France (+1.0% per year) and Italy (+0.5% per year) recorded modest growth while Greece recorded a significant 4.6% contraction for the year to June 2015.

UK

- The Bank of England (BoE) left policy unchanged at its 6 August 2015 meeting, as expected. The Bank Rate was unchanged at 0.5% and the stock of asset purchases remained at £375bn. There was one dissent on the nine member board, the first since December 2014. Market expectations continue to point towards the first hike in the Bank Rate in Q1 2016.
- The second estimate of Q2 2015 GDP was unchanged at 0.7%per quarter and 2.6%per year. The unemployment rate held steady at 5.6% for the three months to June 2015. Average weekly earnings excluding bonuses was recorded at 2.8%per year to June.

NZ

- The Reserve Bank of New Zealand (RBNZ) did not meet in August with the next meeting due on 10 September 2015. At its previous two meetings the RBNZ cut the official cash rate to 3%.
- Q2 2015 labour market data was released, with employment growth weaker than

expected, rising 0.3% over the quarter, equating to 7000 extra people employed. The unemployment rate rose to 5.9% from 5.8%, while the participation rate fell to 69.3% from 69.5%.

- The New Zealand dollar fell 3.8% against the US dollar over the month on growth concerns and weaker dairy prices. Fonterra cut its 2015/16 farmgate milk price forecast by $NZ1.40 to $NZ3.85/kg of milk solids.

Canada

- The Bank of Canada (BoC) did not meet in August with the next meeting due on 9 September 2015.
- During the month given the heightened financial market volatility and falls in energy prices, the Canadian dollar fell below the level it reached against the US dollar during the GFC, finishing the month at $US0.7610. Given recent falls in the oil price, markets have lifted the chance of another rate cut by the Bank of Canada. The Bank of Canada has cut the official cash rate twice to 0.5% this year, but it remains above the GFC low of 0.25%.

Japan

- The Bank of Japan's (BoJ) policy board convened on 7 August 2015 and left its qualitative and quantitative easing (QQE) program at an annual increase of ¥80trillion to its monetary base.
- The preliminary estimate of Q2 2015 GDP was released, with growth negative in the quarter at -0.4% per quarter. While this was slightly better than consensus expectations it was still a disappointing result. Weak consumption, which fell 0.8% per quarter, was the main cause and the recovery in exports has taken longer than expected despite falls in the yen.

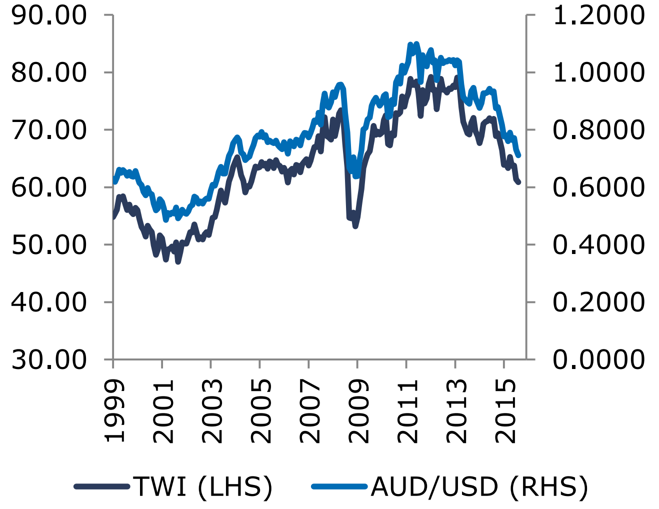
China

- Weak economic data, including the Caixin Purchases Managers Index (PMI) led to heightened concerns about a slowdown in China’s economy. The Caixin PMI fell to 47.8 in August, the lowest in the series of the index. Export growth also slumped, falling 8.1%per year to July.
- This and the expected first interest rate hike by the US Federal Reserve sparked the People’s Bank of China (PBOC) to announce on 11 August a “one-off depreciation” in the exchange rate. Immediately the Yuan weakened 1.9% against the US dollar, the most on record. In an official statement the PBOC stated the daily fixing of the exchange rate will reference the previous day’s market closing rate as well as daily demand and supply, making it more reflective of market forces.
- This will also help meet the International Monetary’ s Fund need for the Yuan to be more flexible to meet the requirements to be included in its Special Drawing Right’s basket of currencies.
- Chinese equity markets also traded with volatility on renewed growth concerns, following on from heavy losses in June and July and sparked global market volatility.
- The Chinese authorities are facing three challenges; an economic slowdown, equity market volatility and capital outflows from its currency depreciation.
- With authorities finding it hard to fight all three battles, priority has been given to the currency and growth target with both the 1-year lending rate and Reserve Requirement Ratio cut by 25 basis points and 50 basis points respectively in August. Further easing measures are expected over the remainder of 2015.

Australian dollar

- As with other markets, foreign exchange markets traded with volatility. The Australian dollar finished down 2.7% against the USD in August to $US0.7113 and finished the month on its lows. This is the lowest level since April 2009 and reflects ongoing growth concerns in China, weaker commodity prices and the anticipated first interest rate hike in the US.
- The Australian dollar also moved sharply lower against both the euro (-4.6%) and the Japanese yen (-4.8%) and in the case of the later reflected some safe haven buying of the yen.
- In contrast the Australian dollar rose 1.8% against the sterling and 1.2% against the New Zealand dollar.

AUSTRALIAN DOLLAR DOWN SHARPLY

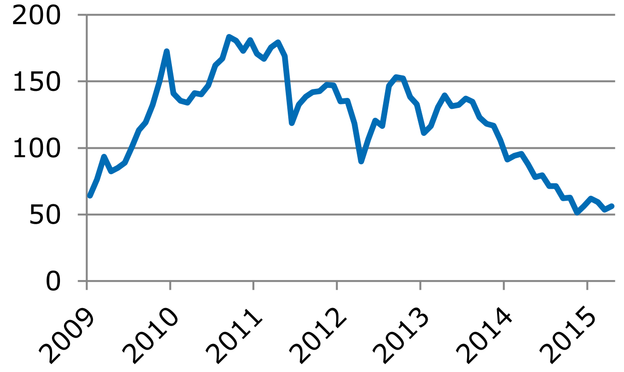


Source: Bloomberg as at 31 August 2015

Commodities

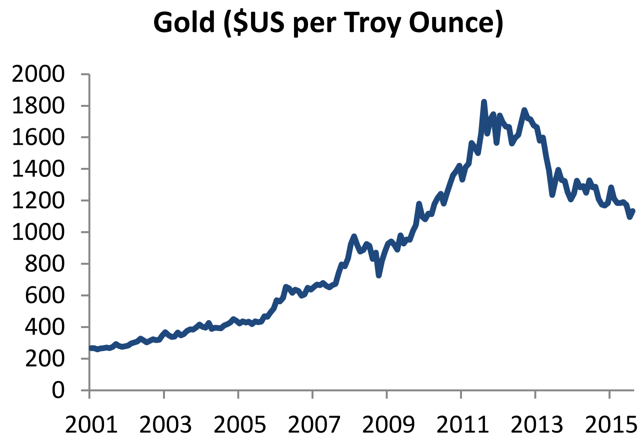
- Commodity prices traded with extreme volatility in August, weighed down by the escalating growth concerns in China.
- The oil price traded in a wide range, with the price of West Texas Intermediate Crude finishing the month up 4.4%. This hides the falls the oil price encountered for much of the month, starting August at $US45.17/barrel, falling as low as $US38.09 (a six-year low) before ending the month at $US49.2. The recovery was led by lower US production estimates and reports OPEC was ready to "talk to all other producers".
- The iron ore price, as measured by the benchmark price of iron ore delivered to Qingdao China – 62% Ferrous Content rose 5.2% to $US56 a metric tonne.
- Most metal prices were weaker in August, reflecting financial market volatility and China growth concerns. Tin (-12.9%), nickel (-8.9%) and zinc (-5.6%) were the weakest performers.
- Copper (-1.8%) and aluminium (-0.9%) also fell while lead (+1.8%) and gold (+3.6%) were higher.

IRON ORE PRICE WEAKER



Source: Bloomberg as at 31 August 2015

GOLD LOWEST IN FIVE YEARS



Source: Bloomberg as at 31 August 2015

Australian equities

- The Australian equity market had its most volatile month for nearly four years in August. The S&P/ASX 200 Index closed the month 7.8% lower after trading in a wide range. The Index had fallen by around 12%, before recovering some of these losses in the last few days of the month.
- Sentiment towards equities globally remained fragile, partly reflecting a heavy sell-off in the Chinese stock market. Chinese economic indicators also gave investors cause for concern. Given China accounts for more than a quarter of Australian exports, the pace of growth is important for ASX-listed companies.
- Domestically, most ASX-listed companies announced their results for the six or 12 months ending 30 June 2015. Consensus earnings expectations for FY16 declined modestly during the 'reporting season', with most companies suggesting that trading

conditions remain challenging. Self-help initiatives, including an ongoing focus on costs, remain on the agenda for most ASX-listed companies.

- On the whole, companies continued to increase dividends to income-hungry investors. The average dividend payout ratio among ASX 200 companies has reached 75%. Dividend payouts are rising at a quicker pace than earnings; suggesting companies are satisfying investors' demand for income rather than reinvesting profits for growth.
- In company news, Commonwealth Bank of Australia (-11.4%) and ANZ Banking Group (-14.5%) raised an additional $5 billion and $3 billion of equity respectively in August. These moves were in response to the more stringent capital requirements that are being imposed on the major banks by the regulator, the Australian Prudential Regulation Authority.

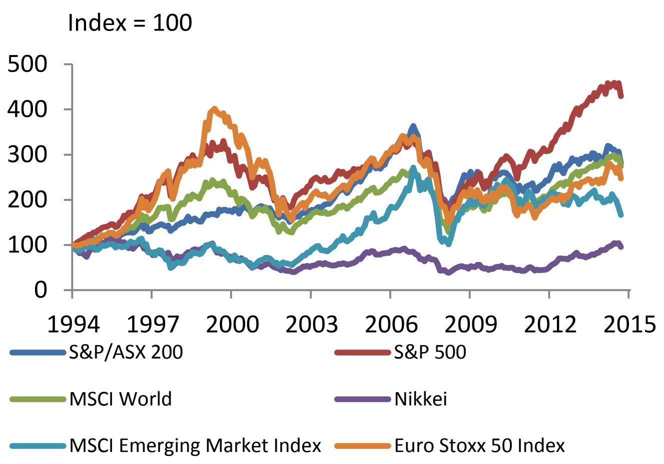
Listed property

- Australian property securities also weakened in August, albeit by much less than the broader market. The S&P/ASX 200 Property Accumulation Index returned -4.1%, but is still up more than 14% over the past year.
- The Retail sub-sector remained the best performing area of the property market in August, with companies exposed to discretionary expenditure continuing to outperform. Scentre Group (-1.2%) and Westfield Group (-1.1%), for example, performed well relative to peers.
- Most companies announced results for the six or 12 months ending 30 June. There were few real surprises in the releases. Mirvac Group (-7.4%), Stockland (-8.0%) and Lend Lease (-8.9%) all reported record residential contracts, reflecting ongoing strength in the Sydney new property market, in particular. Offshore property securities were also affected by the sell-off in global share markets. The UBS Global Property Investors' Index returned -5.9% in USD terms. Continental Europe was the best performing region, declining by just -0.5%. Hong Kong was the poorest performing region, registering a -12.6% return.

Global developed market equities

- Global developed equity markets traded with extreme volatility in August, led by weaker economic data in China and the move to depreciate the currency. An increase in market volatility was always anticipated ahead of the first lift in official interest rates in the US given this would mark the first increase in rates since 2006 and the start of divergence of central bank policy since the GFC. While debate continues about the exact timing of the first rate rise in the US, markets are expected to trade with volatility around this announcement.
- All major global equity markets fell in August. Overall the MSCI World Index fell 6.8% in USD terms and 4.3% in AUD terms.
- The S&P500 (-6.0%), the Dow Jones (-6.2%) and the NASDAQ (-6.7%) finished the month down by off the lows. On 24 August the Dow Jones opened with a large 1089 index point fall at the height of the volatility and recorded its biggest three day fall on record, before recovering into month end.
- The Chicago Board Options Exchange SPX Volatility Index, a market estimate of future volatility, spiked at 40.7 on 24 August, a level last seen in 2011.
- MSCI Financials (-7.9%) and MSCI Healthcare (-7.5%) fell heavily in the month as did MSCI Energy (-6.3%) and MSCI Materials (-7.7%).
- Equity markets in Europe were also weaker. The German DAX (-9.3%), France (-8.5%), Spain (-8.1%) and Italy (-6.8%) all fell. The UK FTSE 100 was down 5.8% for the month.
- In Asia, the Japanese Nikkei 225 fell 8.2% while Hong Kong (-11.8%) recorded sizeable losses given the volatility on the various mainland Chinese equity indices. Singapore also retreated, down 8.1% for the month of August.

EQUITY MARKETS MIXED



Source: Bloomberg as at 31 August 2015

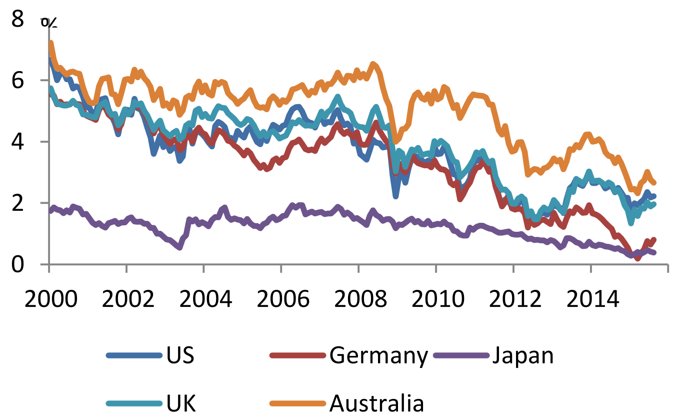
Global emerging markets

- August was a challenging month for emerging market equities, debt and currencies. Both the issues in China and the anticipated first rate hike in the US have created mass volatility. China, Vietnam and Kazakhstan made changes to their currency regimes over the month, while the Malaysian Ringgit fell 9.2% in the month.
- Emerging market (EM) equities fell 9.0% (MSCI Emerging Market Index), taking the losses over three months to 17.4%, in US dollar terms.
- The Shanghai Composite Index lost 12.5% taking returns over 2015 to date to just 0.6%. The government unlike previous falls in June and July did not actively support the equity market.
- MSCI Emerging Markets Latin America fell 10.7% in the month, led lower by Brazil.

Global and Australian developed market fixed interest

- Global bond markets were wrought with volatility in August as investors jumped from one side of the fence to the other on when the US Federal Reserve will commence rate normalisation. In major markets, 10-year government bond yields traded in a wide range between 30 and 40 basis points.
- The exception again was Japan, where the 10-year JGB yield traded within a 10bps range and ended the month only 3bps lower.
- Despite the volatile trading ranges, month-on-month changes in major bond markets were muted. A surge in crude oil prices on the last day of the month drove bond yields slightly higher and the US, UK and Germany 10-year bond yields closed up (4, 8 and 15bps respectively) over the period.
- The 10-year US Treasury yield traded in a 39 basis point range during the month but finished August relatively flat, up just 4bps to 2.22%. Increased volatility was to be expected as we get closer to the next Federal Open Market Committee Meeting (FOMC) on 16-17 September.
- The 10-year German bund yield traded in a 29 basis point range, before closing the month up 15 basis points at 0.80%.
- Movements in the UK Gilt market followed the trends in the US Treasury and German bund markets. The yield on the 10-year gilt traded in a 32bps range in August but overall only moved by 8bps, up to 1.96%.
- In Japan, the 10-year JGB yield fell 3bps to 0.38%, and traded in a relatively narrow range of 9bps.
- In Australia the benchmark 10-year government bond yield traded in a 38 basis point range during August. However, despite the volatility the yield was only down 9bps to 2.66% at the end of August impacted more by continued concerns over China's growth outlook.

BOND YIELDS FALL IN JULY



Source: Bloomberg as at 31 August 2015

Global credit

- Over the month, global credit spreads drifted wider as investor sentiment was impacted by economic events, particularly China's growth concerns. The Barclays Global Corporate Aggregate spread widened 10 basis points in the month, closing at 1.54%. The Barclays European Aggregate Corporate Index closed at 1.25%, widening by 10bps in August, and the Barclays US Aggregate Corporate Index finished the month at 1.55%, widening by 9bps.
- US High Yield credit spreads widened significantly in August as the high yield market was particularly impacted by the increased volatility. The Bank of America Merrill Lynch Global High Yield index (BB-B) spread closed 44bps wider at 4.74%.
- Asian credit markets also weakened in August, with the JPMorgan Asia Credit Index (JACI Composite) average spread widening by 29bps to 2.94%.
- In line with their global counterparts, Australian credit spreads drifted wider as investor sentiment was impacted by economic events, particularly China's growth concerns. The average spread of the Bloomberg AusBond Credit Index relative to swap moved from 89bps to 95bps

Index return

	Index Level in Base Currency	1 month	12 month
S&P/ ASX200 Index	5,207	-8.6%	-7.4%
S&P / ASX 200 Accumulation Index	46,788	-7.8%	-3.2%
MSCI WORLD (AUD)		-3.3%	26.5%
MSCI World Net Index AUD Hedged		-6.7%	3.9%
Dow Jones Index	16,528	-6.6%	-3.3%
UK FTSE 100	6,248	-6.7%	-8.4%
German DAX Index	10,259	-9.3%	8.3%
France CAC Index	4,653	-8.5%	6.2%
Japan - Nikkei	18,890	-8.2%	22.5%
Hong Kong – Hang Seng	21,671	-12.0%	-12.4%
MSCI EM (EMERGING MARKETS) (AUD)		-5.8%	1.7%
US 10 year bond yield	2.22%	4bps	-13bps
Australia 10 year bond yield	2.66%	-9bps	-63bps
UBS All Maturities Composite Bond Index	8,561	0.6%	6.3%
90 Day Bank Bill Index	2.15%	0bps	-48bps
Bloomberg AusBond Bank Bill Index	8,304	0.2%	2.5%
S&P / ASX 200 - A-REIT Accumulation Index	37,331	-4.1%	14.2%
AUD/USD (end of month)	0.7113	-2.7%	-23.8%
Oil price	$US49.2/barrel	4.4%	-48.7%
Gold price	$US1134.8/ounce	3.6%	-11.9%

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